BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SERVICE AMUSEMENTS, INC.)

Appearances:

For Appellant: Fleharty, Berg & Guntner, Attorneys at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Service Amusements, Inc., to proposed assessments of additional franchise tax in the amounts of $8,573.32, $16,041.91, $21,642.51, $26,332.66 and $40,040.56 for the income years 1951 through 1955, respectively.

Appellant conducted a coin-machine business in and near Fresno. It owned pinball machines and other types of amusement games which were placed in more than 200 locations such as taverns, restaurants, bowling alleys and similar establishments. Under the arrangement with each location owner Appellant was required to maintain the machine in proper working order; the location owner furnished the electricity to operate the machine; Appellant retained the key to the coin box in the machine and a representative of Appellant visited the location periodically to open the machine and count the coins.

At the time of each collection the location owner informed Appellant's representative of the amount of the expenses paid by the location owner in connection with the operation of the machine and this amount was set aside for him from the coins in the machine. The balance was divided equally between Appellant and the location owner. The expenses initially paid by the location owners included cash payouts to players of pinball machines for free games not played off and taxes and licenses assessed against the machines.

Appellant's representative made out a collection report showing the name of the location, the date, the gross amount in the machine, the expenses, the net amount to divide, and the division. However, after August 5, 1954, the gross amount and the expenses were omitted and the collection reports. showed only the net amount to divide and the division,

Respondent's auditor examined the complete file of collection reports for the period from May 3, 1951, to August 5, 1954, and prepared summaries to determine the gross amount deposited in the machines, the expenses, the location owners' share and Appellant's share. The amounts by year are as follows:

May 3, 1951, to December 31, 1951

			% of Gross
Gross Amount in Machines		$218,100.88	100.000
Less:			
Taxes	$8,473.07		3.885
Other	78,567.18		36.024
		97,040.25	39.909
Net Amount to Divide		131,060.63	60.091
Location Owners' Share		65,374.83	29.974
Appellant's Share		65,685.80	30.117

1952

			% of Gross
Gross Amount in Machines		$ 404,979.63	100.000
Less:			
Taxes	$13,982.75		3.453
Other	143,788.73		35.505
		157,771.48	38.958
Net Amount to Divide		247,208.15	61.042
Location Owners' Share		123,466.80	30.487
Appellant's Share		123,741.35	30.555

1953

			% of Gross
Gross Amount in Machines		$541,329.35	100.000
Less:			
Taxes	$15,674.50		2.896
Other	200,647.40		37.065
		216,321.90	39.961
Net Amount to Divide		325,007.45	60.039
Location Owners' Share		162,446.50	30.009
Appellant's Share		162,560.95	30.030

January 1, 1954, to August 5, 1954

			% of Gross
Gross Amount in Machines		$335,941.25	100.000
Less:			
Taxes	$10,562.50		3.144
Other	143,035.60		42.578
		153,598.10	45.722
Net Amount to Divide		182,343.15	54.278
Location Owners' Share		91,172.58	27.139
Appellant's Share		91,170.57	27.139

Appellant reported its share of the division as its gross income on its franchise tax return. Appellant deducted therefrom its business expenses such as rent, salaries, and depreciation. The remaining balance was considered to be its net income to be used as the measure of the tax.

Respondent has recomputed Appellant's gross income on the theory that Appellant rented space in each location and paid a rental to the location owner for the space and that all the coins deposited in the machines were the gross income of Appellant. The recomputation for the period from May 3, 1951, to August 5, 1954, was based on the collection reports. For the period from August 6, 1954, to December 31, 1955, Respondent assumed that Appellant's share was 27.139% of the gross amounts in the machines. This was the percentage which Appellant's share was of the gross during the period from January 1, 1954, to August 5, 1954.

In addition to recomputing gross'income, Respondent disallowed all expenses pursuant to Section 24203 (now 24436) of the Revenue and Taxation Code, which section went into effect on May 3, 1951. Section 24203 read:

> In computing net income, no deductions shall be allowed to any taxpayer on any of its gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Fart 1 of the Penal Code of California; nor shall any deduction be allowed to any taxpayer on any of its gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

Appeal of Service Amusements, Inc.

Section 330a of the Penal Code makes it a crime to possess or control a "mechanical device, upon the result of action of which money . . . is . . . hazarded, and which is operated .o. by ... depositing therein any coins ... and bv means whereof ... money ... is won or lost ... when the result of action ...of such machine ... is dependent upon hazard or chance." Section 330a is a part of Chapter 10 of Title 9 of Part 1 of the Penal Code of California.

Copies of 26 collection reports have been placed in evidence. These are printed forms and have the name "Service Amusements, Inc." at the top, The forms have lines for various entries including date, name of location, total amount in machine, tax, expense, deduct (the total of tax and expense), merchant's share, balance due operator, remarks, merchant% signature and collector's signature. Some of the entries on these collection reports were as follows: Total 104.00, deduct 71.00, remarks-16.00 over Meter; total 62.00, payout 30.00, net 32.00, remarks-Reg. reading 24.65; total 151.00, payout 70.00, net 81.00; total 61, J. Pot & P.O. 57, net 4; total 180.00, Pay-outs 40.00, net 140.00; total 180.00, Ace Hi punch board, deduct 94.00, net 86.00; total 16.00, payout 21.00; total 80.00, city lic 25.00, deduct 40.00, net 15.00; total 60.00, 44 Features, 14 on meter, deduct 58.00, net 2.00; total 76.00, payout 30.00, net 46.00; total 108.00, P.O. 30 J P 48, deduct 78.00, net 30.00 total 65.00, payout 18.00, net 47.00, remarks-Reg reading 13.00; total 94.00, merchant 's share 47.00, balance due operator 47.00, remarks-4.00 over Meter; total 260.00 payout 202.00, net 58.00, remarks-11.00 over reg; total 543.00, deduct 341.00, net 202.00, remarks-Hit 45.00 Feature-Pick up tickets no Pay-19.00; total 223.00, deduct 125.00, net 98.00, remarks-Hit Feature 43.00; total 59, deduct 71, net-12, remarks-(12 in Hole); total 16, Fed tax 10.00, P.O. 4.00, deduct 14, net 2; total 143.00, deduct 87.00, net 56.00, remarks-9.60 over Meter; total 443, deduct 234, net 209, remarks-15.40 over meter; total 56.00, deduct 38.00, net 18.00, remarks-7.45 over meter; total 156.00, P.O. 58.00, net 98.00; total 110, P.O. 52, net 58.

A location owner testified that the pinball machine at his place of business during the period in question was owned by Appellant, that players could win free games, that cash payouts were made to players for free games not played off, that when a cash payout was made a button on the underside of the machine was pressed and the free games would be removed and that a meter inside the machine recorded the number of free games thus removed. He also stated that he kept a separate record of payouts, that the collector gave him money from the machine equal to what his record showed, that the balance was divided equally, that the collector checked the meter and that his record and the meter were always quite close. The machine was exchanged for another at frequent intervals, usually for a bally brand machine. Some

of the machines were multiple odd, that is, machines in which the player could deposit additional nickels to increase the number of free games won for a given winning combination.

Another location owner testified that he had sometimes one and sometimes two pinball machines owned by Appellant, thatthe machines had removal buttons, that cash payouts were made to players for free games not played off, that a record of cash payouts was kept, that the collector gave him money from the machine equal to his record of cash payouts and that the balance was divided equally.

From the testimony of the location owners, the collection reports placed in evidence and the summaries of Appellant's records we conclude that it was the general practice to make cash payouts to players for free games not played off.

Respondent made no physical examination of the machines owned by Appellant. Respondent, however, has had many types of pinball machines examined by an engineer of which the following types are shown by the records to have been owned by Appellant during the period in question:

Balley	United
Beauty	Tahiti
Palm Springs	Wevada
Dude Ranch	Rio
Bright Lights	ABC
Spot Light	
Variety	
Beach Club	
Surf Club	
Atlantic City	
Yacht Club	
Palm Beach	
Ice Frolics	

Based on the engineer's opinion, Respondent is of the view that these games were games in which a player's success was determined primarily by chance rather than by skill. Respondent also believes that most of the other machines owned by Appellant were games of chance.

Appellant at the time of filing its appeal indicated that it considered its machines "to be primarily games of skill" but there was no other statement in this regard giving details of the mechanical features. Subsequently Respondent filed its brief and alleged that Appellant's pinball machines were of the "multiple-coin, multiple-odds type, with the scoring panel usually arranged

in a bingo pattern" and were "predominantly games of chance." Still later Appellant filed a comprehensive brief and discussed most of the points covered in Respondent's brief. However, this brief of Appellant did not mention the subject of chance or skill nor the mechanical features of the pinball games. This brief also assumed that if cash payouts were made, there was a violation of Section 330a of the Penal Code but contended that Appellant did not have possession or control of the machines and therefore that the violation would be by the location owner alone. Appellant requested an oral hearing but made no appearance at the hearing and presented no evidence.

The foregoing considerations lead us to the conclusion that Appellant does not seriously contend that the machines on which cash payouts were made were games of skill. Upon the basis of the evidence presented at the hearing and the briefs filed herein, we find that they were games of chance. Respondent was therefore correct-in concluding that the operation of such machines violated Section 330a of the Penal Code and that Section 24203 of the Revenue and Taxation Code was applicable.

The operating arrangements between Appellant and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958 (2 CCH Cal. Tax Cas., Par. 201-197), (3 P-H State & Local Tax Serv., Cal., Par. 55,145). Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of the machines is, accordingly, applicable here. Respondent's assessments therefore must be revised to reduce Appellant's gross income from 100% to 50% of the coins deposited in the machines,

Respondent's computation of the amount of coins deposited in the machines from May 3, 1951, to August 5, 1954, was made directly from Appellant's collection reports. It appears, however, that Appellant's records did not show all the amounts deposited in the machines, although the amounts omitted were probably quite small. For example, one collection report shows no expenses but under remarks states "4.00 over Meter" indicating that expenses were claimed by the location owner in an amount $4.00 in excess 0f the cash payouts as computed from the meter in the machine. Respondent's auditor also testified that there were a few missing collection reports and that the amounts on them could not be determined by reconciling to bank deposits because petty disbursements had been made from the cash on hand before depositing it in the bank. Since such unascertained omissions from gross income appear to be minor in amount and favor the Appellant, they may be disregarded for purposes of this appeal.

For the period from August 6, 1954, to December 31, 1955, Respondent computed the total amounts deposited in the machines

by assuming that Appellant's share of the division of the net proceeds was the same percentage of the gross as it had been in the period from January 1, 1954, to August 5, 1954. This was a reasonable assumption and in fact the best possible basis for making such a computation where Appellant's records did not show the gross amounts deposited in the machines.

In Appeal of C. B. Hall, Sr., supra, we held that, the illegal activity having been established by the evidence, Respondent's action in disallowing deductions was presumptively correct and the burden of proving error was on the taxpayer. Appellant has presented no evidence. It may be inferred, therefore, that all the expenses either were incurred in the illegal activity or were incurred in a legal activity which was associated or connected with the illegal activity. On this basis and since Respondent's action was not patently arbitrary, the disallowance of all expenses must be sustained.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Service Amusements, Inc., to proposed assessments of additional franchise tax in the amounts of $8,573.32, $16,041.91, $21,642.51, $26,332.66 and $40,040.56 for the income years 1951 through 1955, respectively, be and the same is hereby modified in that the gross income is to be recomputed in accordance with the Opinion of the Board. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 18th day of July, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary